COUNTY OF LOS ANGELES
DEPARTMENT OF AUDITOR-CONTROLLER

KENNETH HAHN HALL OF ADMINISTRATION
500 WEST TEMPLE STREET, ROOM 525
LOS ANGELES, CALIFORNIA 90012-2766
PHONE: (213) 974-8301 FAX: (213) 626-5427

J. TYLER McCAULEY
AUDITOR-CONTROLLER

October 18, 2005

TO: Supervisor Gloria Molina, Chair
Supervisor Yvonne B. Burke
Supervisor Zev Yaroslavsky
Supervisor Don Knabe
Supervisor Michael D. Antonovich

FROM: J. Tyler McCauley
Auditor-Controller

SUBJECT: **DEPARTMENT OF PUBLIC SOCIAL SERVICES FACILITY LEASES**

We have completed a review of certain County leasing transactions for building space that is principally occupied by the Department of Public Social Services (DPSS). This review commenced in December 2002 when we requested the State Controller to examine the building space costs claimed to federal and State programs for the DPSS facility located at 11110 West Pico Blvd. in West Los Angeles. Our request was subsequently referred to the U.S. Department of Health and Human Services (HHS), Division of Cost Allocation. HHS raised a number of questions and recommended that we review the reasonableness of the County's leasing arrangement for the DPSS facility in West Los Angeles. This lease was the third of four similarly executed lease transactions. In December 2004, HHS requested that we obtain independent appraisal reports for the other three DPSS facilities (one located in Glendale and two in El Monte). Our review included interviewing personnel, reviewing various documents, and obtaining an independent appraisal of the West Los Angeles facility.

On September 1, 2005, we were notified (see Attachment I) by the Director of the HHS Division of Cost Allocation that conclusions had been reached regarding (1) the appropriateness of operating leases, and (2) the reimbursement of rental costs at four specific public assistance program facilities. We have responded to HHS (see Attachment II) by indicating agreement with their conclusions and informing them of the measures to be taken by the County to resolve the concerns which were raised.

The detailed findings and results of our review (see Attachment III), along with the HHS conclusions, have been discussed with the Chief Administrative Office (CAO). The CAO concurs with the response to HHS as well as the specific actions that are to follow in terms of implementing policies that will comply with federal and State building space reimbursement requirements. In addition, we recommend that the Auditor-Controller be required to review all leases that involve subvention by third parties to ensure federal and State guidelines are followed.

If you have any questions, please contact me at (213) 974-0383 or John Naimo at (213) 974-8484.

JTM:JN:JS
h:\lease analysis report.doc

Attachments

c: David E. Janssen, Chief Administrative Officer
Raymond G. Fortner, County Counsel
Bryce Yokomizo, Director, Department of Public Social Services

ATTACHMENT I

DEPARTMENT OF HEALTH & HUMAN SERVICES

Program Support Center
Financial Management Service
Division of Cost Allocation

DCA Western Field Office
50 United Nations Plaza, Room 347
San Francisco, CA 94102

SEP 01 2005

(Revised 10/11/05)

J. Tyler McCauley
Auditor-Controller
County of Los Angeles
500 West Temple Street, Room 525
Los Angeles, CA 90012-2766

Dear Mr. McCauley:

In December 2002, the Office of the Los Angeles County Auditor-Controller requested the California State Controller's Office (SCO) and HHS to assist in reviewing certain leases. As a result, the HHS Division of Cost Allocation (DCA) began a review of four leases which the County of Los Angeles (County) had entered into to acquire facilities for County public assistance programs.

This letter summarizes the DCA conclusions on two areas: (1) appropriateness of operating leases and (2) allowability of lease costs under public assistance programs.

Appropriateness of Operating Leases:

The County had entered into long-term (30-50 years) operating leases for facilities under subvented public assistance programs. The County used operating leases instead of capital leases because it felt that operating leases are financially advantageous to the County. For example, the cost of an operating lease is claimable when incurred. However, certain claiming limitations in accounting for capital leases can create cash flow shortfalls for the County.

In a letter dated March 27, 2003, the DCA expressed concern that the use of operating leases rather than capital leases for long-term needs (e.g. public assistance programs) is not cost effective for either the county or for state and federal governments providing subventions. An operating lease creates no equity in the property for the County and the public assistance programs must pay for the rental costs for as long as they remain in the facility or must lease other facilities after the lease expires. This will be costly for public assistance programs in the long term.

Status/Action: The County has stated that it has reconsidered the practice of using only operating leases for subvented programs. We were informed that the County Board of Supervisors has recently approved the use of a capital lease to acquire a new public assistance facility.

Phone: (415) 437-7820 • FAX: (415) 437-7823 • E-mail: dcasf@psc.gov

Rental Cost of Four Facilities:

We reviewed the four public assistance facilities that the County obtained using operating leases. OMB Circular A-87 (paragraph 38 of Attachment B) states that rental costs under operating leases are allowable if reasonable in light of costs of comparable property. Thus, we requested the County to obtain appraisals of these facilities. The appraisal reports provided an opinion on the fair market rent for each facility after analyzing comparable rentals for the facilities. We used the reported fair market rents as a basis of our determination of the allowable costs under OMB Circular A-87. As a result, we conclude that annual claimable costs (see attached details), over the life of the leases, should not exceed the following amounts:

11110 West Pico Boulevard, Los Angeles	**$2,366,856**
3350 Aerojet Avenue, El Monte	**$2,404,800**
3400 Aerojet Avenue, El Monte	**$3,254,400**
4680 San Fernando Road, Glendale	**$2,188,800**

In addition, the facility located at 3350 Aerojet Avenue, El Monte was occupied on January 1, 2001. However, lease charges began on August 1, 2000. Thus, the rent paid prior to the occupancy date is not claimable under Federally subvented programs.

Status/Action: The County should make adjustments to subvented programs to assure that previous and future claims are consistent with the amounts cited above and any lease costs paid prior to the occupancy of a facility is not claimed.

We appreciate the cooperation that your office has given to us in this review. Within 30 days of the date of this letter, please advise me of the actions you have taken or plan to take in regard to the two issues presented above.

Sincerely,

David S. Low
Director

Attachment

cc: Mike Harvey, Office of the California State Controller
Douglas D. Park, California Department of Social Services
Norma Tucker, California Department of Health Services

Attachment

Los Angeles County Department of Social Services
Analysis of Facility Leases

Description	Rentable Area	Lease Term	Date Occupied	Rent Start		Claimable Rent ©		Lease Costs	Difference
Department of Public Social Services 11110 West Pico Boulevard Los Angeles	69,450	30 years	'3/15/02	'3/01/02	ANNUAL MONTHLY PER S.F.	**$2,366,856** $197,238 $2.84	 (A)	$3,166,098	($799,242)
El Monte Phase I 3350 Aerojet Ave El Monte, CA	120,000	30 years	'1/01/01	'8/01/00	ANNUAL MONTHLY PER S.F.	**$2,404,800** $200,400 $1.67	 (B)	$2,481,288	($76,488)
El Monte Phase II 3400 Aerojet Avenue El Monte, CA	120,000	30 years	'6/01/03	'6/01/03	ANNUAL MONTHLY PER S.F.	**$3,254,400** $271,200 $2.26	 (D)	$3,506,813	($252,413)
Glendale Public Social Services 4680 San Fernando Road Glendale, CA	80,000	25 years	9/12/00	9/16/00	ANNUAL MONTHLY PER S.F.	**$2,188,800** $182,400 $2.28	 (E)	$2,438,400	($249,600)
Total									($1,377,743)

Notes:
© Bolded amount is the claimable rent beginning on the date of occupancy.

(A) Claimable amount of $2.84 is calculated as follows:	
Gross Rental Income	$31.20
Plus Extra Tenant Improvements	$2.91
Per SF Annual	$34.11
Per SF Monthly	$2.84

Backcasting Rental Costs

Location	Lease Date	Appraisal Date	Years Backcast	Market Rent	Backcast 3% Per Year	
3350 Aerojet Avenue	2000	2005	5	$1.95	$1.67	(B)
3400 Aerojet Avenue	2003	2005	2	$2.40	$2.26	(D)
4680 San Fernando Road	2000	2005	5	$2.65	$2.28	(E)

ATTACHMENT II

COUNTY OF LOS ANGELES
DEPARTMENT OF AUDITOR-CONTROLLER

KENNETH HAHN HALL OF ADMINISTRATION
500 WEST TEMPLE STREET, ROOM 525
LOS ANGELES, CALIFORNIA 90012-2766
PHONE: (213) 974-8301 FAX: (213) 626-5427

J. TYLER McCAULEY
AUDITOR-CONTROLLER

October 18, 2005

Mr. David S. Low, Director
Division of Cost Allocation
U.S. Department of Health and Human Services
DCA Western Field Office
50 United Nations Plaza, Room 347
San Francisco, CA 94102

Dear Mr. Low:

We previously requested your assistance in determining the claimable amount of building space costs for the County's Department of Public Social Services (DPSS) facility in West Los Angeles. In response to your letters dated March 27, 2003 and March 26, 2004, we have reviewed the County's lease arrangement for the DPSS facility in West Los Angeles. Our review included interviewing personnel, reviewing various documents, and obtaining an independent appraisal of the West Los Angeles facility. In addition, as you requested, we obtained independent appraisal reports for three additional DPSS facilities located in Glendale and El Monte.

In your letter dated September 1, 2005, you indicated that the HHS Division of Cost Allocation (DCA) had reached a conclusion regarding (1) the appropriateness of operating leases, and (2) the reimbursement of rental costs at four specific public assistance program facilities. You requested that we notify you of actions that we plan to take on these issues.

In response to your most recent letter of September 1st, the County accepts the conclusions indicated in your letter and is taking the following actions:

- **The County will develop a formal policy of using capital leases when entering into long-term build-to-suit leases where the County intends to operate reimbursable programs over an extended period of time. The County's recent real estate transactions have already demonstrated intent to comply with such a policy.**

- **The Auditor-Controller will work with the County's Department of Public Social Services (and all other departments, as applicable) to make all requested adjustments to reimbursement claims that have previously been**

filed for the West Los Angeles facility and the three other facilities leased under similar terms and conditions.

- **For the term of the leases, the County agrees to claim the *lower* of its actual costs or the reimbursement levels for each of the four buildings cited in your letter.**

In addition, as a result of our review and your inquiries related to this matter, the County is taking the following actions:

- **The County will ensure the adequacy of documentation when procuring building space (including build-to-suit leases), including the criteria used to select the recommended proposal and the reasons for any variances from the County's standard RFP procedures.**

- **The County will institute procedures to specifically demonstrate and document compliance with federal guidelines and the State's *Handbook of Cost Plan Procedures for California Counties* when entering into building space rental agreements.**

- **For the West Los Angeles lease (and all other leases as applicable), the County will ensure that the contractor requires the Trustee to establish the Operation and Maintenance Reserve Fund and the Renewal and Replacement Fund as required by the lease.**

- **At the end of each fiscal year, the County will assign responsibility to reconcile payments made for operation and maintenance expenses for all leases requiring the County to pay those expenses to actual expenditures incurred for the fiscal year and adjust the payments accordingly.**

- **The County will ensure that the Trustee keeps any County Additional Payments and Reserve Fund interest not needed to pay current expenses in the Trustee's Operation and Maintenance Fund to pay future expenses or in the Operation and Maintenance Reserve Fund.**

We will provide our Board of Supervisors with the detailed findings of our review and the reasons for the above-referenced measures that are to be implemented.

Appropriateness of Operating Lease

Financial Accounting Standards Board Statement 13 establishes criteria for categorizing leases as either operating or capital leases, and provides accounting rules based on the type of lease. There are also different federal reimbursement rules for different types of leases.

The County's leases for the West Los Angeles DPSS office and three other buildings were intentionally structured as operating leases and have been classified as such for financial reporting and claiming purposes. There is a perception that the reimbursement for costs incurred under an operating lease is favorable when compared with a capital lease transaction. An operating lease cost is generally reimbursed as it is incurred, thereby matching budgetary and cash flow requirements. Although a capital lease transaction reasonably provides reimbursement of building and interest costs, it does not provide for reimbursement of land costs. In addition, the recovery of building costs is generally limited to an annual use allowance that is amortized at 2% per year over fifty years.

To assess the reasonableness of this transaction, we noted that the operating lease method of acquiring building space has been utilized in situations where the tenant department relies heavily on federal and State reimbursement. In comparison, facilities that are used to provide other governmental services on a long-term basis (such as health care and public safety) are generally financed in a manner that results in eventual ownership to the County. This suggests that the County can reasonably structure the acquisition of public assistance facilities in a manner that accumulates equity and results in eventual ownership of the property. This approach should also alleviate many of the concerns expressed by HHS with regard to the West Los Angeles facility and others that were leased under similar terms and conditions.

On May 17, 2005, the Board of Supervisors approved a 30-year capital lease agreement to acquire 210,000 square feet of office space, most of which is to be occupied by the County's Public Social Services, Children and Family Services, and Mental Health Departments. The decision to acquire this space via a capital lease transaction was largely influenced by the concerns raised by HHS.

- **The County will develop a formal policy of using capital leases when entering into long-term build-to-suit leases where the County intends to operate reimbursable programs over an extended period of time. The County's recent real estate transactions have already demonstrated intent to comply with such a policy.**

Rental Cost of Four DPSS Facilities

We previously obtained an independent appraisal of the market value of the West Los Angeles facility. HHS has relied upon this appraisal to conclude that the annual claimable costs for this facility shall not exceed $2,366,856. This amount is nearly $800,000 lower annually than the rental cost payable by the County. The most significant factor contributing to this difference includes an approximate $3.8 million difference between the appraised value of the land ($4.2 million) compared with the actual cost ($8 million).

On December 3, 2004, HHS requested us to obtain an appraisal of the market rental rate for three additional DPSS facilities at the locations shown below. Each of these facilities utilized a leasing structure similar to the West Los Angeles facility.

3350 Aerojet Ave., El Monte (El Monte I)
3400 Aerojet Ave., El Monte (El Monte II)
4680 San Fernando Road, Glendale

Table I shows a comparison of the appraised and actual lease rate. Note: Under Lease Rate Basis, "NNN" refers to a triple net lease, in which the lessee is responsible for operating and maintenance expenses. "FSG" refers to a full service gross lease, under which the lessor is responsible for operating and maintenance expenses.

Table I

		Appraised rental value		**Actual Lease Rate**	
Facility	**Lease Rate Basis**	**Monthly**	**Rent/sq ft/mo**	**Monthly**	**Rent/sq ft/mo**
El Monte I	NNN	$ 234,000.00	$ 1.95	$ 206,774.00	$ 1.72
El Monte II	NNN	$ 288,000.00	$ 2.40	$ 292,234.38	$ 2.44
Glendale	FSG	$ 212,000.00	$ 2.65	$ 203,200.00	$ 2.54

Source: Appraisal reports prepared by Integra Realty Resources – Los Angeles

Based on the appraisal results, the actual lease rates for these three facilities are comparable to current (2005) market rental rates. However, the actual rates were established at the inception of the lease and we have agreed to discount the current appraised rental values by 3% per year for each year of occupancy. The resultant rental values, after applying the 3% discount per year, appear as part of the Attachment to the September 1, 2005 HHS letter and are nearly $600,000 lower annually than the rental cost paid by the County.

We also compared the dates for which rental costs were first incurred with the occupancy dates.

Address	Occupancy Date	Rent Start Date
11110 West Pico Blvd., WLA	March 15, 2002	March 1, 2002
3350 Aerojet Ave., El Monte	January 5, 2001	August 1, 2000
3400 Aerojet Ave., El Monte	June 1, 2003	June 1, 2003
4680 San Fernando Rd., Glendale	September 12, 2000	September 16, 2000

Except for one of the El Monte sites (3350 Aerojet Ave.), rental costs were incurred in a manner consistent with initial occupancy. For 3350 Aerojet, rental costs were incurred and claimed approximately five months prior to occupancy. It appears that rent commenced when the building was substantially completed in August 2000; however, the City of El Monte did not issue a Certificate of Occupancy until November 28, 2000, and it subsequently took DPSS approximately five weeks to move into the facility.

HHS has requested that the County adjust previous reimbursement claims for rent that was claimed by the County in excess of the maximum rent allowable by HHS. The cumulative difference, from the rent start dates through September 1, 2005, is nearly $4.96 million. The County has also been directed to adjust its claims for the approximate $1.034 million difference related to rent payments on the El Monte facility which commenced five months prior to occupancy.

- **The Auditor-Controller will work with the County's Department of Public Social Services (and all other departments, as applicable) to make all requested adjustments to reimbursement claims that have previously been filed for the West Los Angeles facility and the three other facilities leased under similar terms and conditions.**

- **For the term of the leases, the County agrees to claim the *lower* of its actual costs or the reimbursement levels for the four buildings cited in the Attachment to the September 1, 2005 letter.**

Review of DPSS West Los Angeles Facility

<u>Background</u>

According to DPSS and CAO staff, DPSS searched for approximately ten years for a facility in West Los Angeles. Because of the nature of the facility and the limited amount of available office space, the County was unable to find a suitable location in an existing building. Therefore, in April 1999, the County issued a Request for Proposals (RFP) for a build-to-suit lease for a facility specifically designed to meet the County's needs. The County received bids from three proposers and selected Sonnenblick Del Rio (SDR) as the facility's developer.

SDR's proposal included bringing a municipal entity into the transaction in order to maximize the County's reimbursement and ensure tax-exempt status. SDR brought the City of Los Angeles (City) into the DPSS transaction. Under the arrangement, the City would finance the purchase of the land and the construction of the building using tax-exempt Certificates of Participation (COP). The City would then lease the building from Sonnenblick-Del Rio West Los Angeles Leasing Corporation (SDRWLA), a non-profit subsidiary of SDR, the building's developer, and then lease the building to the County. At the end of the lease, the City would get title to the property.

On January 15, 2000, the City signed a capital lease for the facility at 11110 West Pico Boulevard with SDRWLA. The same day, the County leased the building from the city under an operating lease. The County's lease has a 30-year term, with five five-year options to renew the lease.

Because of the innovative terms of the lease, the Auditor-Controller requested State and federal cognizant agencies to review the lease and assist in determining the allowable amount of building space costs. Based on concerns expressed by HHS regarding the transaction, we reviewed the RFP process and attempted to evaluate the reasonableness of the cost of the lease.

Review of RFP Process

As noted earlier and as discussed below, the CAO used an RFP to obtain bids for the DPSS facility. County policy states that procurement of build-to-suit leases should be done using an RFP process. Alternatively, the policy permits the Board of Supervisors to direct the acquisition of a specific site or property without a formal RFP process.

While the CAO did use an RFP to obtain bids for the facility, the CAO did not follow typical RFP procedures in evaluating the bids. Normally, County personnel are responsible for evaluating the bids received in response to an RFP and documenting the final recommendation. The CAO's letters to the Board on August 24, 1999 and January 4, 2000 indicated that a committee consisting of a real estate consultant, along with representatives from DPSS, DCFS, Public Works, and the CAO participated in reviewing the proposals. The real estate consultant issued a report indicating that the SDR proposal was the most financially advantageous for the County. However, the consultant indicated that it was very important for the County to obtain additional information from the responding bidders prior to making a final selection.

The CAO Real Estate Division eventually obtained approval from the County Board of Supervisors and the County Real Estate Management Commission to enter into the lease agreement with SDR. However, the consultant did not furnish a final recommendation and there was no documentation available to disclose how the final selection was made.

- **The County will ensure the adequacy of documentation when procuring building space (including build-to-suit leases), including the criteria used to select the recommended proposal and the reasons for any variances from the County's standard RFP procedures.**

Evaluation of Building Cost and Related Lease Charges

Federal OMB Circular A-87, Attachment B, 37(a), states "rental costs are allowable to the extent that the rates are reasonable in light of such factors as: rental costs of comparable property, if any; market conditions in the area; alternatives available; and, the type, life expectancy, condition, and value of the property leased."

Section 3560 of the State's *Handbook of Cost Plan Procedures for California Counties* states:

"1. Counties must obtain three comparable rates for privately-owned space in the same general locality. The following information must be obtained for each comparable address: monthly rent amount; cost per square foot and/or per parking space; whether services are included in the rate; and the number of parking spaces available.

2. If the county states that there are no comparable facilities, it should obtain an estimate of rental rates by a certified real estate appraiser.

3. The cost per square foot of a building, including maintenance, utilities, alterations, taxes, etc., may not materially exceed the cost of the highest comparable in order for the cost to be appropriate for state/federal financial participation."

We noted that the County's lease rate is based on repayment of the COPs issued to finance the project. Therefore, to evaluate the reasonableness of the lease rate for the West Los Angeles facility, we asked SDR to provide us with information on the cost of acquiring the land and constructing the building. However, SDR claimed that, because the County was not a party to the land acquisition or construction contracts, there were legal and contractual constraints that prevented SDR from providing cost information to the County.

Because SDR would not provide us with information on the actual cost of the facility, we attempted to use other methods to estimate its cost. We obtained the cost of the land from the escrow closing statement. We estimated the cost of building the facility from the amount of the construction bond posted by the general contractor. In addition, we estimated the developer fee by subtracting the cost of land and the amount of the construction bond from total amount deposited into the Project Fund by the City.

Cost of Land	$ 8.0 million
Est. Construction cost (bond)	23.9 million
Est. Developer Fee	1.5 million
Total estimated land and improvements	$33.4 million
Capitalized Interest	4.7 million
Costs related to COP issuance	1.8 million
Reserve Fund	3.2 million
Total COP proceeds	$43.1 million

To verify the estimated cost of land and improvements, we obtained an independent appraisal of the market value of the facility as of January 15, 2000. Appraisers generally use three methods to value property: cost, sales comparison, and income capitalization. Because the value obtained using the cost approach should approximate the cost to construct the facility, we compared the cost appraisal amount to our estimated cost.

The adjusted appraised value of the facility ($28.3 million) is $5 million less than our estimate of the total cost of land and improvements ($33.4 million). It appears that the major difference is in the cost of the land which the appraiser estimates at $4.2 million, compared to the escrow statement cost of $8 million. Part of this difference may be due to the fact that the appraised value does not include the cost to buy out the existing business on the site or the cost to demolish the building. However, these issues do not appear to account for the entire $3.8 million difference. In addition, the appraised value includes $1.4 million in construction loan interest. However, since construction costs were paid for from the proceeds from the City's COPs, there should be no additional construction loan interest.

We also noted that construction costs for underground parking are higher than costs to construct above ground parking. Due to extremely limited parking available in the area and height restrictions on the building site, the decision to provide underground parking at this facility for employees and clients appears to have been reasonable.

- **The County will institute procedures to specifically demonstrate and document compliance with federal guidelines and the State's Handbook when entering into building space rental agreements.**

Comparison of Costs

We did compare the impact of classifying the West Los Angeles facility lease as an operating or capital lease. Assuming that the facility costs, including financing costs and operation and maintenance costs, are the same under a capital or operating lease, and that the County would employ the use allowance method for claiming under a capital lease, we noted the following:

- The total cost to all parties (federal, State and County) over a 55-year period for an operating lease is $61 million higher than the total cost for a capital lease over the same period. This is primarily because the County will continue to pay/claim rent in years 31 to 55 under the current operating lease, but would not pay rent during those years under a capital lease.

- The County's net cost under an operating lease in years 31 to 55 is $21 million higher when compared with a capital lease. This amount consists of the following factors: 1) under an operating lease, the County continues to pay rent and incurs a local net cost (after claiming) of approximately $5 million and 2) under a capital lease, the County owns the facility, avoids additional rent expense, and continues to claim an annual 2% building use allowance that generates net revenues of approximately $16 million.

- The County's net cost under the current operating lease is $20 million lower in the first 30 years of the lease than it would be under a capital lease. This is primarily because OMB A-87 rules for capital leases under the use allowance method require building costs to be claimed over 50 years, even though the County must pay for the building over a 30-year period. In addition, the County would not be able to claim the cost of the land under a capital lease.

- When compared with a capital lease, an operating lease facilitates matching annual budgetary expenditures with reimbursement revenues. However, the County foregoes the opportunity to accumulate equity in the land and building improvements and the appreciation in their values over an extended period.

- The period for claiming building costs could be less than 50 years under the depreciation method. However, current OMB A-87 rules require that entities claiming under the depreciation method use that method for all like-type fixed assets such as buildings. Therefore, if the County were to use the depreciation method to claim building costs for the West L.A. facility, the County would have to change the method of claiming for all buildings the County either owns or leases under a capital lease.

Allowable Costs

We evaluated costs the County claimed to State/federal programs for the DPSS facility in Fiscal Year (FY) 2002-03 to determine whether they were allowable. The primary issue with allowable costs relates to the amount of lease payments attributable to the Reserve Fund. The Reserve Fund is an amount to be held by the Trustee equal to one year's County rent payments. The Reserve Fund was established from the proceeds of the City's COPs. Part of the County's ongoing lease payments are based on repaying the amount of the Reserve Fund.

Under OMB A-87, contributions to a contingency reserve are not allowable. Therefore, it appears that the County's lease payments related to the Reserve Fund are not allowable. Lease payments related to the Reserve Fund amount to approximately $233,000 a year. However, it should be noted that the County receives interest on the balance of the Reserve Fund. DPSS uses the interest earnings to offset its facility operation and maintenance expenses. DPSS does not claim these offset costs (approximately $220,000 per year) on their State/federal programs. Although the claimed costs related to the Reserve Fund ($233,000 a year) are almost completely offset by operating costs that DPSS has not claimed, these issues should handled by only claiming the allowable operating costs.

We also noted that, although the lease requires SDR to have the Trustee establish the Operation and Maintenance Reserve Fund and the Renewal and Replacement Fund, the Trustee had not established these funds as of June 30, 2004. Therefore, the County did not claim any amounts to State/federal programs related to these funds. We also noted that at the time we began our review, the developer had not been sending trustee statements to the CAO Real Estate Division as required by both the West Los Angeles and El Monte leases.

- **For the West Los Angeles lease (and all other leases as applicable), the County will ensure that the contractor requires the Trustee to establish the Operation and Maintenance Reserve Fund and the Renewal and Replacement Fund as required by the lease.**

Operations and Maintenance Costs

We reviewed operating and maintenance costs charged to the County for FY 2003-04 to determine whether the charges were reasonable. As a result of our review, we noted that the operating expenses for FY 2002-03 per the property management company's budget appear reasonable compared to industry standard costs. However, we also noted that the amount paid by the County plus the Reserve Fund interest from February 2002 to April 2004 exceeded the actual and budgeted operation and maintenance costs by $352,000. To recover the amounts overpaid to the property management company, the County temporarily stopped paying Additional Payments in April 2004. Accordingly, the County did not claim operation and maintenance expenses to State/federal programs for months the County did not pay Additional Payments.

- **At the end of each fiscal year, the County will assign responsibility to reconcile payments made for operation and maintenance expenses for all leases requiring the County to pay those expenses to actual expenditures incurred for the fiscal year and adjust the payments accordingly.**

- **The County will ensure that the Trustee keeps any County Additional Payments and Reserve Fund interest not needed to pay current expenses in the Trustee's Operation and Maintenance Fund to pay future expenses or in the Operation and Maintenance Reserve Fund.**

Within sixty days, we will provide you with a follow up status report that provides time frames and responsible parties within the County for each issue above.

If you have any questions, please contact me at (213) 974-0383 or John Naimo at (213) 974-8484.

Very truly yours,

J. Tyler McCauley

J. Tyler McCauley
Auditor-Controller

JTM:JN:JS
h:\lease analysis report-to HHS.doc

Attachment

c: Each Supervisor
David E. Janssen, Chief Administrative Officer
Bryce Yokomizo, Director, Department of Public Social Services